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CABINET AFFAIRS STAFFING MEMORANDUM

DATE: August 4, 1982 NUMBER: 072841CA DUE BY: --

SUBJECT: Statement by OMB Director before the Senate Budget Committee

	ACTION	FYI
ALL CABINET MEMBERS	☐	☑
Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☐	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
CEA	☐	☐
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐

	ACTION	FYI
Baker	☐	☐
Deaver	☐	☐
Clark	☐	☐
Darman *(For WH Staffing)*	☐	☐
Harper	☐	☐
Jenkins	☐	☐
Gray	☐	☐
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	☐	☐
CCCT/Kass	☐	☐
CCEA/Porter	☐	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The attached is forwarded for your information.

RETURN TO:

☑ **Craig L. Fuller**
Assistant to the President
for Cabinet Affairs
456-2823

☐ **Becky Norton Dunlop**
Director, Office of
Cabinet Affairs
456-2800

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
Tuesday, August 3, 1982

STATEMENT OF THE HONORABLE DAVID A. STOCKMAN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SENATE BUDGET COMMITTEE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am here today to discuss the Mid-Session Review of the 1983 Budget and to express my support for the First Budget Resolution and the actions the Senate has taken to implement it.

Last year's Congressional Budget Resolution and the Omnibus Budget Reconciliation Act of 1981 made a significant start on curbing the unsustainable rate of growth in Federal spending for nondefense programs. This year's resolution, if fully effected, will make another very substantial contribution to this critical effort. Implementation of the Resolution will lower the rate of growth of Federal spending from more than 17% in 1980 to about 7 1/2% in 1985. It will reduce the Federal spending share of GNP by an average of a full percentage point each year -- from 24% in 1982 to 21% in 1985.

THE BUDGET OUTLOOK, 1981-1987
(in billions of dollars)

	Actual	Estimate			
	1981	1982	1983	1984	1985
Receipts	599.3	622.1	646.5	719.9	801.1
Outlays	657.2	731.0	761.5	812.5	874.7
Surplus or deficit (-)..	-57.9	-108.9	-115.0	-92.6	-73.6
Addendum: Percent of GNP					
Receipts ...	21.0	20.5	19.3	19.4	19.6
Outlays ...	23.0	24.1	22.8	21.9	21.4

The above figures are based on the Mid-Session Review of the 1983 Budget, which was released last Friday. In the past, this Review has served as an update to the President's budget estimates. While this year's Review serves that purpose in a technical sense, in practice it is really an update of the First Budget Resolution.

Although different in many respects from the Administration's budget presented last February, the First Budget Resolution is consistent with the general thrust of Administration economic policy, particularly the commitment to sustained deficit reductions as a means of strengthening prospects for steady interest rate reductions and sustained economic recovery. The Administration therefore considers successful legislative implementation of the Resolution to be its most immediate fiscal priority.

Economic Assumptions

To further prospects for this implementation, the Review is designed to serve the limited purpose of updating the Resolution only for recent economic and budget data. It does not reflect a reassessment of the economic forecast or the budget policies that underlie the Budget Resolution. Such a reassessment would be premature at this time.

The economic assumptions in the Mid-Session Review are essentially those used by the Congress in the preparation of the Resolution, modified to reflect recent actual data for the first half of 1982, plus Administration estimates of their near-term effects on the second half of the year. The primary difference for 1982 in the Mid-Session Review is lower projected inflation. As shown in the accompanying table, from the beginning of 1983 onward, the rates of change of prices and output, and unemployment and interest rates are those assumed in the Resolution.

Use of the Resolution economic projections in the Mid-Session Review does not constitute Administration endorsement of these assumptions as forecasts or as economic policy objectives. They are used instead to conform as much as possible with estimates in the Resolution and to facilitate enactment of the critical deficit reduction measures that it embodies.

COMPARISON OF ECONOMIC ASSUMPTIONS
(Calendar years)

	1982	1983	1984	1985
Nominal GNP ($ billions):				
Mid-Session Review	3090	3436	3812	4190
Resolution	3116	3493	3875	4259
Difference	-26	-57	-63	-69
Growth Rates (percent changes, fourth quarter over fourth quarter):				
Nominal GNP:				
Mid-Session Review	6.9	11.7	10.6	9.6
Resolution	8.5	11.7	10.6	9.6
Real GNP:				
Mid-Session Review	1.7	4.4	4.0	3.5
Resolution	1.6	4.4	4.0	3.5
GNP Deflator:				
Mid-Session Review	5.1	7.0	6.3	5.9
Resolution	6.9	7.0	6.3	5.9
Unemployment Rate:				
Mid-Session Review	9.2	8.4	7.6	7.2
Resolution	9.1	8.4	7.6	7.2
91-Day Bill Rate:				
Mid-Session Review	12.0	10.7	8.8	6.9
Resolution	12.0	10.7	8.8	6.9

Economic Appraisal

As indicated, the principal objective of the Mid-Session economic assumptions is to conform with estimates in the Budget Resolution, while taking account of economic developments thus far in calendar 1982. However, in an effort to continuously monitor economic conditions, our current appraisal suggests that the recent chorus of growing economic pessimism is unwarranted. Inflation has declined, and this move toward lower inflation is laying the groundwork for a steady and sustainable economic recovery. Business conditions have clearly bottomed, and there are numerous signs of improvement that suggest the economy has entered a turning zone, moving from recession to recovery.

The most important factor in the outlook for recovery is the substantial progress that has been made in controlling the rampant inflation inherited by this Administration. No matter what the inflation measure, the progress is impressive. Averaging changes in four different measures -- the consumer price index, the producer price index, hourly earnings, and the GNP deflator -- the inflation rate has been cut nearly in half during the past 18 months. In the 12 months before this Administration took office, the average inflation rate was almost 11 percent; in the past 12 months, it has been brought down to 6 percent.

INFLATION RATES
(percent change from one year earlier)

Year Ending	CPI	PPI	Wages	GNP Deflator	Average Inflation Rate
Dec. 1980	12.4	11.8	9.3	10.2	10.9
Jun. 1981	9.6	10.5	9.0	9.4	9.6
Dec. 1981	8.9	7.1	8.2	8.9	8.3
Jun. 1982	7.1	3.5	6.9	6.8	6.1

The decline in inflation during this recession, roughly one-third, has been sharper than in any other in the past 3 decades. During past recessions the decline in average CPI inflation has been much smaller, roughly only one-twentieth. Moreover, there is considerable evidence that inflationary expectations have receded, and this is nowhere more evident than in commodity and tangible asset markets.

The disruptive speculative behavior that brought gold, silver, and other commodity prices to astronomical heights during 1978-80 -- and brought the dollar to new lows -- has been reversed. The level of the dollar has reached a 10-year high, and unproductive commodity speculation has been curbed, as reflected in the following table:

PRICES OF COMMODITIES AND TANGIBLE ASSETS

	Peak Since Late 1980		June 1982	Percent Change
Commodity Price Index 1/ ..	298	(Nov 80)	240	-19.5
Raw Materials Index 1/....	305	(Nov 80)	233	-23.6
Gold ($/oz)	664	(Oct 80)	312	-53.0
Silver ($/oz)	20	(Oct 80)	5	-75.0
Copper (¢/lb)	99	(Oct 80)	68	-31.3
Old Masters Paintings 2/..	255	(Sep 80)	209	-18.0
Continental Ceramics 2/...	336	(Sep 80)	266	-20.8
Crude Petroleum Index	843	(Mar 81)	719	-14.7

1/ Source: Commodity Research Bureau
2/ Source: Sotheby's Index

The combination of lower inflation and incentive-oriented tax-rate reduction points strongly toward an across-the-board strengthening in purchasing power and a sustained pickup in economic activity. The evidence in recent months indicates that the recession has bottomed and the economy is displaying the early signs of improvement that are characteristic of the turning zone of recovery.

- o Real disposable income increased at an annual rate of 3.1% during the second quarter.

- o Real personal consumption expenditures rose by 3.0% in the second quarter, following a 2.5% rise in the first quarter.

- Real hourly earnings have been positive since December, the first such sustained rise in real wages in 3 years.

- As a sign of consumer improvement, retail sales in the second quarter increased at a 13.4% annualized rate, or 10.5% adjusted for inflation.

- New housing permits have increased by 28.5% during the past 8 months, and real residential construction investment grew by an annualized 3.1% in the second quarter.

- The ratio of nonfarm inventories to final sales of goods and structures peaked in the fourth quarter of 1981 at 4.64, and declined to 4.57 in the second quarter of 1982. With inventories pared back, and final demand on the rise, production and employment will be picking up during the months ahead.

As a last note on the current economic scene, no discussion is complete without touching on the difficult interest rate situation. In response to higher deficits, financial market participants and people throughout the economy remain concerned over the future behavior of interest rates. If left unresolved, this anxiety is likely to

diminish prospects for a lasting economic recovery. Of course, it is precisely for this reason that the Administration is placing so much emphasis on the need for successful legislative implementation of the entitlement, other spending and tax measures provided in the First Budget Resolution passed by Congress.

However, on the brighter side, it is worth noting that the overall inflation reduction and the considerable progress achieved thus far on the Budget Resolution have generated a salutory effect on interest rates. Indeed, financial market conditions have been gradually unwinding throughout most of 1982. The 3-month Treasury bill rate has been averaging below 11% in recent weeks, compared to a 17% peak in June of last year. In recent days, the bill rate has been trading around 9 1/2%. The prime rate has dropped to 15% from a peak of 21% in December 1980, and further prime rate reductions are expected during the weeks ahead. These interest rate reductions are of particular importance in the current economic environment, and if continued they would become a key factor in the recovery picture during the second half of 1982.

Budget Outlook

The budget implications of the differences in economic assumptions between the Mid-Session Review and the Resolution are substantial, principally because of the lower inflation in calendar year 1982. The lower inflation results in reductions in GNP relative to the Resolution of $55 to $70 billion per year in the 1983-85 period, and therefore results in reductions in receipts of $15 to $20 billion per year. Although the increases to the deficit resulting from the reductions in receipts are partially offset by technical reestimates and other differences in the Mid-Session Review, the deficits are nevertheless significantly higher than in the Resolution.

MID-SESSION AND RESOLUTION DEFICITS
(in billions of dollars)

	1983	1984	1985
Resolution deficit	104	84	60
Deficit effect of:			
Reduced receipts (largely due to revised incomes)	19	18	20
Reduced outlays (largely due to technical reestimates)	-8	-9	-7
Mid-Session deficit	115	93	74

The Mid-Session Review deficits, while higher than the Resolution, are much lower than the preliminary deficit projections presented to this Committee last week. Based on their technical estimates of last Spring, and their preliminary assessment of the economic outlook, CBO projects deficits of about $150 billion per year in the 1983-85 period. About 40% of the increase in the projected deficits relative to the Mid-Session Review is due to economic assumptions. Most of the remaining 60% is due to technical estimating differences.

MID-SESSION AND PRELIMINARY CBO DEFICITS
(in billions of dollars)

	1983	1984	1985	1983-85 Total
Mid-Session deficit	115	93	74	281
Revised economic assumptions ...	8	28	31	67
Technical reestimates rejected in Resolution:				
Receipts	5	11	22	38
Outlays	8	9	11	28
Subtotal	12	21	33	66
Additional technical reestimates in the Mid-Session Review:				
Unemployment compensation ..	3	3	3	9
Net interest	2	3	5	10
Social security, Medicare and Medicaid	1	3	2	6
Other	2	2	1	5
Subtotal	8	11	11	30
Policy differences	2	-1	2	3
Total differences	31	59	76	166
Revised CBO deficit 1/	146	152	150	448

1/ Assumes midpoint of CBO range
Note: Detail may not add to total due to rounding

Memorandum: Share of estimating differences between Mid-Session and CBO:

	1983	1984	1985	1983-85 Total
Economic assumptions	26%	47%	41%	40%
Technical reestimates:				
Rejected in Resolution	40%	35%	43%	40%
Additional	27%	19%	14%	18%
Total	67%	54%	57%	58%
Policy	7%	-1%	2%	2%
Total	100%	100%	100%	100%

Budget Impact of Disinflation

The economywide shift to lower inflation, the recession that has accompanied it, and the temporary occurrence of extraordinarily high real interest rates has had dramatic effects on the budget outlook. Lower nominal GNP growth, due both to lower inflation and to the recession, is the major contributor to the increased deficits. As shown in table below, the shortfall in receipts that results from the shortfall in nominal GNP occurs not only with respect to the Administration's March 1981 forecast but also with respect to the CBO forecast made at the same time. Receipts in each year are reduced by $70 to $100 billion due to the GNP shortfall, and this receipts shortfall has resulted in a substantial increase in debt service costs.

BUDGET EFFECT OF REVISED ECONOMIC ASSUMPTIONS
(in billions of dollars)

	1983	1984	1985
Change in GNP (calendar years):			
Administration March 1981 to July Mid-Session	-264	-286	-310
CBO March 1981 to July Mid-Session	-231	-273	-373
Effect of Revised GNP on Receipts (fiscal years):			
Administration March 1981 to July Mid-Session	-80	-74	-79
CBO March 1981 to July Mid-Session	-70	-70	-95
Effect of Reduced Receipts on Debt Service Costs (fiscal years):			
Administration March 1981 to July Mid-Session	-6	-15	-23
CBO March 1981 to July Mid-Session	-5	-13	-23

Source: OMB estimates

The effect of disinflation on the spread between inflation and market interest rates has also had dramatic budget effects. The "real" interest rate for 91-day Treasury bills was slightly negative, on average, during the 1970's. In contrast this rate was 5% in calendar year 1981 and is projected to be 5 1/2% in 1982. Neither public nor private forecasts projected these large rates or accurately foresaw their extraordinary budget implications. If real interest rates in the 1980's were the same as in the 1970's, Mid-Session Review estimates of debt services costs would be substantially reduced from current projections, as shown below.

EFFECT OF CHANGE IN REAL INTEREST RATES ON DEBT SERVICE
(in billions of dollars)

	1982	1983	1984	1985
Rate effect	-34	-37	-32	-25
Debt service on lower rates	-3	-6	-8	-11
Total	-37	-43	-40	-36

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* Figures calculated from difference between 1970's average real rate (-0.2%) and real rate assumed in Mid-Session Review.

Reconciliation Progress

The fiscal challenge we face will require determined action over the next several years to achieve our fiscal policy goals. A necessary preconditon for success is to take the essential first step of enacting the deficit reduction measures contained in the First Resolution. And the Administration believes that the Senate is moving responsibly forward in this direction.

In the matter of Reconciliation, Senate Committees have produced legislation that, in our view, signals responsible Senate action. The overall instructions savings are $11.18 billion for FY 1983-85 for bills other than the Finance Committee package already approved by the Senate. We believe the Committee's legislation, if adopted without amendment, would actually exceed the target slightly, producing savings close to $12 billion.

SENATE RECONCILIATION

	1983	1984	1985	1983 to 1985
Resolution entitlement targets ...	-7.7	-11.8	-14.2	-33.7
Reconciliation instruction targets	-6.5	-9.3	-11.3	-27.1
Committee-reported savings:				
Finance Committee Bill 1/.....	-4.1	-5.8	-6.9	-16.8
Other Committees	-2.5	-4.0	-5.7	-12.2
Total Savings	-6.6	-9.8	-12.6	-29.0
Senate Savings as a percentage of:				
Resolution	86%	83%	89%	86%
Reconciliation instructions ..	102%	105%	112%	107%

1/ Passed Senate

The Conference that meets this week, Mr. Chairman, has before it a Finance Committee package that also successfully reflects the Senate's commitment to reach the deficit reduction targets. With persistence, the Administration believes that these measures can be enacted soon.

Finally, the Senate Appropriations Committee has, in our view, also acted to establish 302(b) targets that are consistent with the spirit of the Resolution. While the functional allocation of discretionary authority implicit in those allocations reflects differing priorities from either the Resolution assumptions or the President's budget requests, we believe that the overall task that the Senate set for the Appropriations Committtee can be successfully completed. If the Senate 302(b) allocations are firmly adhered to and all Resolution assumptions regarding current level, entitlement and other additional spending reductions are observed, we believe the Resolution savings for discretionary programs will be achieved.

In all, Mr. Chairman, I would like to commend you and your colleagues for your efforts to move forward in such a determined fashion. We look forward to working with you and the Members of this Committee on this difficult -- but essential task.